Decision 06-08-026 August 24, 2006

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U 338-E) to Modify Decision No. 89-01-040 Waiving the Requirement to File a 2007 Cost of Capital Application.	Application 06-03-029 (Filed March 27, 2006)
Application of Pacific Gas and Electric Company to Modify D.89-01-040, Waiving the Requirement to File an Annual Cost of Capital Application for Test Year 2007. (39 M)	Application 06-03-030 (Filed March 30, 2006)

OPINION WAIVING THE FILING OF TEST YEAR 2007 COST OF CAPITAL APPLICATIONS

I. Summary

This order grants Southern California Edison Company (SCE) and Pacific Gas and Electric Company (PG&E) a waiver from filing a test year 2007 cost of capital (COC) application. SCE and PG&E shall file a test year 2008 COC application by May 8, 2007. This order also grants SCE and PG&E's request to schedule a COC financial modeling workshop.

II. Background

The major energy utilities are required to file test year COC applications on May 8 of each year, pursuant to Decision (D.) 89-01-040.[1] Consistent with that

[1] 30 CPUC2d 576 at 610 (1989).

annual requirement, SCE and PG&E filed their test year 2006 COC applications on May 9, 2005, the first business day following May 8, 2005 which fell on a Sunday.

By D.05-12-043, dated December 15, 2005, SCE was authorized a test year 2006 return on equity (ROE) of 11.60% based on a capital structure of 43.00% long-term debt, 9.00% preferred stock, and 48.00% common stock. For that same test year, PG&E was authorized an 11.35% ROE based on a capital structure of 46.00% long-term debt, 2.00% preferred stock, and 52.00% common stock. COC applications for test year 2007 were scheduled to be filed by SCE and PG&E on May 8, 2006.

III. Requests

SCE and PG&E filed individual applications seeking authority to waive the filing of their test year 2007 COC applications. These applications were filed approximately two and a half months prior to the scheduled filing of their test year 2007 COC applications. Concurrent with these filings, SCE and PG&E each requested and subsequently received an extension of time for filing their respective test year 2007 COC application pending resolution of their waiver applications. These extensions were granted by the Executive Director, pursuant to Rule 48(b) of the Commission's Rules of Practice and Procedure (Rule).[2]

By their applications, SCE and PG&E also seek the scheduling of a workshop to address the appropriateness and relevance of the financial models used in the annual COC proceedings and appropriateness of using other financial models for future COC proceedings.

---

[2] SCE and PG&E were authorized time extensions pursuant to an Executive Director letters of March 30, 2006 and April 3, 2006, respectively.

IV. Discussion

Although SCE and PG&E filed separate applications, both applications raise the same issues. The issues are whether to grant a waiver of filing test year 2007 COC applications and whether to schedule a COC workshop.

The Division of Ratepayer Advocates (DRA) filed nearly identical responses to SCE and PG&E's applications on May 10, 2006 and May 11, 2006, respectively. San Diego Gas & Electric Company (SDG&E) filed separate responses to these applications on April 14, 2006. Aglet Consumer Alliance and The Utility Reform Network (Aglet-TURN) jointly filed nearly identical protests to SCE and PG&E's applications on May 5, 2006.

Rule 55 allows for the consolidation of applications involving related questions of law or fact. Therefore, consistent with Rule 55 and to better utilize the resources of SCE, PG&E, DRA, Aglet-TURN, and Commission staff, Application (A.) 06-03-029 and A.06-03-030 are consolidated.

A. Test Year 2007 COC Application Waiver

SCE seeks a waiver of its requirement to file a test year 2007 COC application on the basis that the conditions that are likely to influence COC decisions have changed little. For example, Moody's Aa Long-term Utility Bond Yield, a factor used in the COC financial models and which is considered in establishing a reasonable COC, has increased only 0.07% from a September 2005 interest rate projection of 6.19% for the test year 2006 to a 6.26% March 2006 projection for the test year 2007.[3] SCE concludes that, all other things equal, its 2007 COC will be higher than its 2006 adopted COC.

---

[3] Similarly, the ten-year treasury interest rate increased only 0.10% from a September 2005 projection for 2006 of 4.87% to a March 2006 projection for 2007 of

Footnote continued on next page

SCE further contends that its financial condition and associated risk has not changed since its test year 2006 COC was approved by the Commission. Specifically, its credit ratings from Moody's and Standard & Poor's show that SCE's financial condition has stabilized since its last COC decision. For example, SCE has maintained a Baa1 issuer credit rating and A3 First Mortgage Bond rating for Moody's since October of 2005. It has also maintained a BBB+ issuer credit rating and Senior Secured Debt ratings from Standard & Poor's since October of 2005.

PG&E also seeks a waiver of its requirement to file a test year 2007 COC application on the basis that the conditions that are likely to influence COC decisions have changed little. This is because the current interest rate environment and outlook through the test year for AA utility bonds, as identified in the above SCE discussion, is largely unchanged from the interest rate information reflected in the Commission's decision for PG&E's test year 2006. Further, PG&E anticipates that its 2007 forecasted cost of long-term debt is virtually unchanged from its 2006 adopted cost.

With regard to its risk profile, such as the structure of the electric industry and resolution of issues such as resource adequacy and customer choice of energy supplier, while still evolving, appears to PG&E to be remaining stable. This stability is reflected in its company credit ratings, which have been unchanged since last upgraded by Moody's and Standard & Poor's in the first quarter of 2005. Both Moody's and Standard & Poor's currently assign a "stable"

4.97%. For the same comparable period, the 30-year Treasury rate increased only 0.03% from 5.06% to 5.09%.

outlook to PG&E's credit ratings, indicating to PG&E that no changes in the ratings are expected in the foreseeable future.

DRA confirms that SCE and PG&E's interest rate outlook for AA utility bonds has not changed significantly from the interest rate information used by the Commission in setting test year 2006 COC for these utilities. Although DRA acknowledges that it proposed a lower return on equity in the last COC for SCE and PG&E, the adopted return on equities was, in part, based on an interest rate forecast for 2006 that is very similar to the current interest rate outlook for 2007. Because of this stable interest rate outlook and the stable credit ratings of SCE and PG&E identified in the above paragraphs, DRA concurs with SCE and PG&E that the utilities should be granted a waiver from filing their test year 2007 COC applications.

SDG&E does not oppose SCE or PG&E's requested waiver of their obligation to file test year 2007 COC applications. Consistent with these applications, SDG&E has requested in its petition for modification of D.05-12-043, being addressed separately, deferral of an opportunity to file a test year 2007 COC application.

The only opposition to SCE and PG&E's waiver requests is from Aglet-TURN. Aglet-TURN oppose the waiver because they believe that SCE and PG&E's adopted 2006 COC greatly exceeds a reasonable COC for test year 2007. It is on this basis that Aglet-TURN opposes the waivers and seeks an opportunity to demonstrate that SCE and PG&E's currently authorized returns exceed returns given to other, similarly situated utilities in the United States and Canada; the returns authorized in California are contrary to trends over time of returns authorized in other states; currently authorized returns exceed the utilities' own projections of market returns for their pension funds; and, currently authorized returns exceed financial model results.

COC proceedings are impacted primarily by three components. These components are capital structure, cost of long-term debt, and return on common equity (ROE). Of these three components, SCE and PG&E's capital structures and costs of long-term debt are not expected to change materially in 2007 from their adopted 2006 capital structures and costs of long-term debt. Hence, all other things being equal, the 0.07% forecasted increase in Moody's long-term utility bond yield could require an upward adjustment to the utilities cost of long-term debt and return on common equity resulting in a slight, if any, increase in energy rates to the utilities' ratepayers.

The remaining variability is ROE, which is impacted by the results of financial models, risk assessments and informed judgment. However, financial models currently in use by the parties are based on subjective inputs, the results of which have consistently been disputed, as addressed in the following cost of capital discussion. No party has identified an event or material change in underlying indices that could impact the utilities COC for test year 2007. We have previously waived the requirement to file when there has been no material change in financial circumstances or bond interest rates since the completion of a utility's most recent COC proceeding.[4] SCE and PG&E have undergone extensive COC reviews for their test years 2006 and 2005, which resulted in

[4] D.03-08-063 (2003).

minor changes in their ROE.[5] The waiver requests of SCE and PG&E should be granted on the basis that they have undergone two consecutive COC reviews and that there is an absence of an identifiable event or material change in underlying indices that may impact their test year 2007 COC.

B. Cost of Capital Workshop

SCE recommends that the Commission hold a workshop to address concerns about the appropriateness and relevance of the financial models used to support returns on common equity by the utilities, interested parties and Commission.[6] SCE recommends a workshop because, in its experience, it has proven difficult to fully explore the technical financial issues through the traditional COC applications. By waiving its 2007 COC application, the Commission would have an opportunity to address these concerns through a workshop in place of litigating COC applications and SCE says that would benefit future COC evaluations.

PG&E concurs with the workshop proposal of SCE. PG&E believes that waiving the filing of a 2007 COC application would enable it, other utilities, DRA, and other interested parties to participate in the workshop and benefit future COC proceedings. This position is shared by DRA and SDG&E. DRA also recommends that the workshop also consider alternatives to the required annual COC applications.

---

[5] Between the 2005 and 2006 test years SCE's ROE increased 20 basis points to 11.60% from 11.40% and PG&E's ROE increased 13 basis points to 11.35% from 11.22%. (D.05-12-043 and D.04-12-047.)

[6] Inconsistent inputs into and components of the three traditional financial models used in COC proceedings have been at issue in the last several COC proceedings.

Aglet-TURN takes no position on the workshop proposal.

It has been more than 20 years since the Commission commissioned a consultant firm in 1981 to analyze and critique the various approaches to estimating the cost of equity capital and to explore their use in establishing rates of return for California utilities. An outcome of that process resulted in the use of several financial models to establish a range from which risk factors and informed judgment is applied to determine a fair ROE. The financial models commonly being used in COC proceedings are the Capital Asset Pricing Model (CAPM), Discounted Cash Flow Model (DCF), and Market Risk Premium Model (MRP). The parties[7] in SCE and PG&E's test year 2006 proceeding used variations of the CAPM, DCF, and MRP. Occasionally, parties recommend the use of other financial models, such as a Fama-French model recommended by SCE in last year's COC proceeding.

Parties have agreed that the financial models are objective. However, the parties use different proxy groups, risk-free rates, market risk premium rates, interest rates, and time periods in their respective financial models. The use of these individual inputs results in a disparity in results and disagreement between the utilities and interested parties. For example, in the test year 2006 COC proceeding, there was a 174 basis point[8] difference between PG&E's 11.67% average and Aglet-TURN's 9.93% average ROE from their respective CAPM financial models.[9] Parties also substitute each other's financial model inputs into

---

[7] Active parties that used financial models in the test year 2006 COC proceeding included SCE, PG&E, DRA, Aglet-TURN, and the Federal Executive Agencies (FEA).

[8] One basis point equals 0.01%.

[9] D.05-12-043 (2006), *mimeo.*, pp. 18-21.

the other parties' financial model calculations to support the reasonableness of their individual results and to discredit the results of other parties.[10] The parties have also disagreed on the appropriateness of using certain financial models. Most recently, differences of opinion on use of the CAPM and DCF financial models were expressed in the 2006 and 2005 COC proceedings.

The waiving of test year 2007 COC applications provides us with an opportunity to evaluate the appropriateness and relevance of the financial models and inputs to support returns on common equity, both models and inputs currently being used and other available financial models and inputs. It also provides us an opportunity to consider alternatives to the required annual COC applications. To accomplish this undertaking, an investigation will be opened in the near future to address in a workshop the appropriateness and relevance of the financial models used to estimate the cost of equity capital in the major energy utilities proceedings and alternatives to their required annual COC applications.

V. Category and Need for Hearing

In Resolution ALJ 176-3170 dated April 13, 2006, the Commission preliminarily categorized this consolidated proceeding as ratesetting and preliminarily determined that hearings would not be necessary. Based on the record, we affirm that this is a ratesetting proceeding and that hearings are not necessary.

---

10 PG&E's inputs into the FEA CAPM resulted in an 11.50% CAPM, a 70 basis point increase from the 10.80% calculated by FEA and only 17 basis points lower than PG&E's 11.67%. FEA inputs into PG&E's CAPM resulted in a 9.50% CAPM, a 217 basis point decrease from PG&E's 11.67%, and 130 basis points lower than FEA's 10.80%. (D.05-12-043, *mimeo.*, p. 22.)

VI. Comments on Draft Decision

The draft decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with § 311(g)(1) and Rule 77.7 of the Commission's Rules of Practice and Procedure. Comments were filed on August 3, 2006 by SDG&E suggesting that its petition be incorporated into this proceeding. Due to procedural constraints it will be addressed separately.

VII. Assignment of Proceeding

John A. Bohn is the Assigned Commissioner and Michael Galvin is the assigned ALJ in this consolidated proceeding.

Findings of Fact

1. The major energy utilities are required to file test year COC applications on May 8 of each year.

2. SCE and PG&E filed individual applications seeking authority to waive the filing of their test year 2007 COC applications.

3. SCE and PG&E also seek the scheduling of a workshop to address the appropriateness and relevance of the financial models used in the annual COC proceedings and appropriateness of using other financial models for future COC proceedings.

4. These applications are consolidated pursuant to Rule 55.

5. Moody's Aa Long-term Utility Bond Yield has increased only 0.07% from a September 2005 interest rate projection of 6.19% for the test year 2006 to a 6.26% March 2006 projection for the test year 2007.

6. SCE has maintained a Baa1 issuer credit rating and A3 First Mortgage Bond rating for Moody's since October of 2005. It has also maintained a BBB+ issuer credit rating and Senior Secured Debt ratings from Standard & Poor's since October of 2005.

7. The financial condition and associated risk of SCE has not changed since its test year 2006 COC was approved by the Commission.

8. The current interest rate environment and outlook through test year 2007 for AA utility bonds is largely unchanged from the interest rate information reflected in the Commission's decision for the utilities test year 2006.

9. PG&E's credit ratings have remained unchanged since last upgraded by Moody's and Standard & Poor's in the first quarter of 2005. Both Moody's and Standard & Poor's currently assign a "stable" outlook to PG&E's credit ratings.

10. DRA concurs with SCE and PG&E that the utilities should be granted a waiver from filing their test year 2007 COC applications.

11. SDG&E does not oppose SCE or PG&E's requested waiver of their obligation to file test year 2007 COC applications.

12. SCE and PG&E's capital structures and costs of long-term debt are not expected to change materially in 2007 from their adopted 2006 capital structures and costs of long-term debt.

13. Financial models currently in use for COC proceedings are based on subjective inputs, the results of which have consistently been disputed.

14. No party has identified an event or material change in underlying indices that could impact the utilities COC for test year 2007.

15. We have previously waived the requirement to file when there has been no material change in financial circumstances or bond interest rates since the completion of a utility's most recent COC proceeding.

16. SCE and PG&E have undergone extensive COC reviews for their test years 2006 and 2005, which resulted in minor changes in their ROE.

Conclusion of Law

1. SCE and PG&E should be granted an exemption from filing test 2007 test year COC applications.

2. A workshop should be held in the near future to review and consider the appropriateness of financial models for COC proceedings and alternatives to annual COC applications.

O R D E R

IT IS ORDERED that:

1. Southern California Edison Company (SCE) and Pacific Gas and Electric Company (PG&E) are granted a waiver from filing a 2007 test year cost of capital (COC) application.

2. SCE and PG&E shall file test year 2008 COC applications by May 8, 2007 unless otherwise ordered by the Commission.

3. An investigation shall be opened in the near future to address in a workshop the appropriateness and relevance of the financial models used to set the COC for the major energy utilities and alternatives to annual COC applications.

4. Application (A.) 06-03-029 and A.06-03-030 are closed.

This order is effective today.

Dated August 24, 2006, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
Commissioners